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Research Perspectives

Investment Implications of Tax Reform

After its remarkable resuscitation in the Senate Finance Committee, Federal tax reform has a good chance of becoming the law of the land. The "reform" is really an economic revolution that would leave no part of the U.S. economy unaffected; even though it raises corporate taxes by about $108 billion over the next five years, its overall impact for investors in common stocks is bullish. The reason: By lowering tax rates and eliminating many deductions, tax reform will encourage investors to make decisions based on sound economics rather than on their tax situation. Capital will be invested more efficiently, interest rates will tend to decline and the incentives to work and to save will increase.

The position of taxable investors will be radically changed. With marginal tax rates lower and investment income taxed at the same rate as capital gains, whether long-term or short-term, bonds and high-yield stocks become more attractive compared to municipal bonds, growth stocks or real estate. And trading options and stocks for short-term gains increases in attractiveness relative to holding for the long term.

Structural Improvement in the U.S. Economy

On its face, tax reform might appear to be negative for equity investors. With corporate taxes raised by 20%, corporate cash flow—which has facilitated mergers and share repurchases—will decline significantly. In the longer run, however, tax reform is positive for stocks. Inflation and interest rates will decline and the long-term economic growth rate will be raised by eliminating these major distortions in the way capital is allocated in the U.S. economy.

Under current law, the Investment Tax Credit (ITC) and accelerated depreciation create particularly low effective tax rates for such capital-intensive industries as autos, steel, heavy machinery, paper and chemicals. Partly because they are capital-intensive, these industries earn a lower return on capital than do such service and light-manufacturing businesses as food processing, electronics, broadcasting, media and financial services. Consequently the tax system currently favors investment in less profitable parts of the U.S. economy. Elimination of the ITC, imposition of a minimum tax, a lowering of the statutory corporate tax rate and other changes will rectify this distortion.

Another distortion is that tax shelters, built around the ITC, accelerated depreciation and the ability to write off passive business losses, lure large amounts of capital into unproductive activities.

The third distortion is that the 50% marginal rate currently in the personal tax code encourages taxpayers to purchase homes or apartments whether they need them or not, subsidizes consumption through tax deductibility of interest expense and pushes wealthy individuals into tax shelters. High marginal rates also discourage working to earn additional money. In addition, they discourage saving and raise the rate of interest sought by individual investors.

The combined effect of these changes is difficult to calculate, but since Federal revenues currently amount to roughly one-fifth of GNP the potential impact is clearly enormous. And the mere ability of the U.S political system to produce such reforms will increase both domestic and foreign confidence in the U.S. economy.

But this is not to say that the plan is free of risk because some parts of the U.S. economy work very well under current fiscal arrangements. One of the few areas in which the U.S. economy still has an edge over its Asian competitors is in commercializing new technology. New industries such as biotechnology and microcomputers emerge from government-financed university labs and are then rapidly commercialized by dozens of small start-up companies financed by venture capitalists. Most of these start-ups either fail or are moderate successes, but the few big winners eventually are taken public when the initial public offering market heats up during bull markets. Historical experience suggests that the success of this system hinges on a favorable tax rate on long-term capital gains. The venture capital system thrived in the bull market of the late 1960s, when capital gain taxes were low; collapsed in the bear market of the early 1970s, when the capital gain tax preference was eliminated and many capable entrepreneurs could not find funding in the U.S.; and dramatically revived after 1978, precisely at the time that the capital gain rate was pushed down again. Can the venture capital system, and high-tech America in general, survive a tax reform that has no special incentives to invest in small start-up companies? The answer will depend largely on just how high the effective capital gain rate is in the final bill.

Key Investment Issues

The effect of tax reform on U.S. equities varies tremendously among stock groups. Precise analysis is impossible because details of the Senate package will change significantly in coming weeks. It seems wise, therefore, to focus on the major issues of tax reform.

High-dividend stocks, such as utilities, international oils and food benefit because the tax on dividends will decline, both absolutely and relative to the tax on long-term capital gains.

Conversely, volatile low-yielding stocks, such as software, biotechnology and semiconductors, are intrinsically less attractive investments if a seven-month capital gain is taxed at the same rate as interest income or a quick jump in an option premium.

Among the businesses that fare best are high-tax, consumer-oriented industries such as retailing, media, advertising, household products and retail brokerage, which currently pay out more than 40% of their income in taxes. Certain firms will see earnings rise 15-20%. An added plus is that the individual tax cut should modestly boost consumer spending.

Companies that serve the real estate market, both commercial and residential, are hurt by the Senate bill.

The tax burden of many capital-intensive industries such as utilities, chemicals and electrical equipment will increase, thereby reducing cash flow and putting a damper on acquisitions and share buybacks.

The Investment Tax Credit is sure to be eliminated, effective January 1, 1986. Any companies that are using the ITC on equipment put into place after that date are, in effect, overstating earnings and cash flow. Earnings estimates for such companies will be revised downward in coming weeks.

Tax reform is negative for industries such as steel, heavy equipment, machine tools, biotechnology, airlines and semiconductors that have not had profits over the past several years; the value of their net operating loss (NOL) carryforwards and Investment Tax Credit carryforwards will decline for a variety of reasons. Since they are tax deductions rather than credits, NOLs are automatically less valuable if marginal tax rates decline.

While these various technical effects are important, one must remember that corporations are not primarily in the business of saving taxes. Although the tax liability of many capital-intensive companies will increase, causing a near-term drop in cash flow and perhaps earnings, the long-term growth of revenues and earnings will rise if the the U.S. economy becomes more efficient and competitive and long-term GNP growth increases.

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Additional Information

This issue of Research Perspectives has been excerpted from a report entitled "Investment Implications of Tax Reform" (*Viewpoint* No. 20). The full report includes PaineWebber analysts' preliminary assessment of how the Senate tax plan would affect the industries they cover. For a copy of this *Viewpoint*, call your PaineWebber Investment Executive.